

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company)	
)	Docket No: 10-0481
Petition for Approval of an)	
Agreement with American Lake)	
Water, an “Affiliated Interest” in)	
accordance with Section 7-101 of the)	
Public Utilities Act.)	

DIRECT TESTIMONY OF
JOHN DUROCHER
ON BEHALF OF
THE PEOPLE OF THE STATE OF ILLINOIS

December, 2010

AG Exhibit 1.0

1 **Q. Please state your name and address.**

2 A. My name is John DuRocher, and my business address is 1525 North Wolf Road, Des
3 Plaines, Illinois.

4
5 **Q. What is your occupation?**

6 A. I am the Executive Director of the Northwest Water Commission. I have been employed
7 in local government in Illinois since 1987. I spent 13 years as the chief administrative
8 officer in two municipalities (the Village of Montgomery and the City of Wilmington)
9 and 8 ½ years as the Executive Director of the Northwest Water Commission (my current
10 employer). At the Village of Montgomery, I was responsible, through my staff, for the
11 construction of a lime softening water treatment plant and ultimately all operations of the
12 water department. In the City of Wilmington, I was also ultimately responsible for the
13 operation of a water treatment facility of the same type and all operations. I was directly
14 involved in both communities in the establishment of budgets and water rates for all
15 operations of the municipality. It is important to note that lime softening water treatment
16 facilities required the Responsible Operator in Charge to possess an IEPA Class “A”
17 operator’s license.

18
19 At the Northwest Water Commission, I sign off as the owner on all matters dealing with
20 the State and Federal Governments and their respective agencies, although I am not
21 personally the Responsible Operator. At the Commission I am responsible for all

22 budgeting and rate setting activities and the performance of all plant operators. My duties
23 include budget analysis and rate forecasting.

24
25 **Q. Please describe your educational background.**

26 A. I have a BA in Philosophy from the University of Illinois 1984 and a Masters Degree in
27 Public Administration from Northern Illinois University. My specialty is City
28 Management with a sub-specialty in Finance.

29
30 **Q. Can you describe the Northwest Water Commission?**

31 A. The Northwest Water Commission was established in 1957 as an Illinois unit of local
32 government. We became operational in 1984 very shortly after the Supreme Court
33 allowed certain states access to water from the Great Lakes. The Commission provides
34 water, purchased from the City of Evanston to our four member (owner) municipalities:
35 the Villages of Arlington Heights, Buffalo Grove, Palatine and Wheeling. We operate
36 approximately 45 miles of transmission main, most of which is 60" in diameter, one main
37 pump station, and two (2) booster pump stations. We currently pump about 24.5 million
38 gallons of water per day (MGD) and employ 12 full time persons, including myself.

39
40 **Q. Are you familiar with the contract governing the transmission of water to the**
41 **Northwest Water Commission communities?**

42 A. Yes. The NW Water Commission is party to a contract with the City of Evanston, which
43 delivers water to a connection point to the NW Water Commission's system. I am
44 responsible for the management of the water transmission pipeline between the City of

45 Evanston and the Villages of Arlington Heights, Buffalo Grove, Palatine and Wheeling.
46 The Commission has a very small and talented staff. We do most of the maintenance and
47 system programming of the SCADA system in-house from the Evanston connection to
48 the connections to the member villages – about 45 miles of water mains. Water is
49 delivered to our member receiving stations and becomes their responsibility after that
50 point. We monitor all aspects of water quality and system pressure on a continual basis.
51

52 **Q. What is the purpose of your testimony?**

53 A. I have been asked to review the agreement between Illinois American Water Company
54 (“IAWC”) and American Lake Water (“ALWC”) governing the delivery of Lake
55 Michigan water to IAWC for customers in the Bolingbrook and Homer Glen areas.¹
56

57 **Q. Can you summarize your conclusions?**

58 A. My main concern is the accountability of private, affiliated firms providing water on a
59 cost effective, economical basis. My involvement in the water industry and through the
60 American Water Works Association has led me to believe that providing water on a cost
61 effective basis is essential for community development. In the United States we pay very
62 little attention to the need for water. In the Great Lakes region, we have access to clean
63 and plentiful water. If this asset were to go away or become cost prohibitive, economic
64 development would be seriously impeded. It is my belief that access to drinking water is
65 a basic human right and that the management of water resources should assure that the
66 public receives drinking water on fair and reasonable terms.
67

¹ IAWC Ex. 1.0 at 2.

68 **Q. Can you provide a general description of the contract between IAWC and ALWC?**

69 A. Yes. The parties to the contract are the utility, IAWC, which distributes water directly to
70 consumers, and ALWC, which obtains Lake Michigan water and transports it to certain
71 connection points, or “points of delivery” on the IAWC system. Both IAWC and ALWC
72 are owned by the same parent company, American Water Corporation. ALWC receives
73 Lake Michigan water from the Village of Bedford Park.

74
75 **Q. What does the Agreement provide in connection with the cost of Lake Michigan**
76 **water?**

77 A. Section 7.1 of the Agreement provides a formula for determining the rate ALWC will
78 charge IAWC. One component of the formula is “PW” or “purchased water costs,”
79 which is the cost of purchased water imposed by ALWC’s supplier per 1,000 gallons,
80 multiplied by the “Normalized Total Deliveries.” This formula results in a water charge
81 equal to 85% of IAWC’s Lake Michigan allocation or the average yearly ratio of total
82 water delivered to all ALWC’s customers compared to their total allocations – whichever
83 ratio is lower. Agreement at page 15. Assessing the unit cost based on the volume of
84 consumption using this measure is a good way to keep costs level over multi-year
85 periods, and is consistent with what we do at the NW Water Commission.

86
87 **Q. Does the Agreement add any charges to the purchased water charge?**

88 A. Yes. The formula in Section 7.1, paragraph (a) on page 13 shows that the unit charge is
89 made up of the OM (Operations and Maintenance) charge and the PW (Purchased Water)
90 charge as I described above, multiplied by “F”, a factor defined in the Agreement as $[1 +$

(15%/1-IT)], where IT = sum of all federal, state, and local taxes. As a result, the unit cost for water includes the cost of purchased water, subject to the normalization factor, and is increased by the F factor. IAWC's workpapers show that the F factor for 2010-2011 equaled 1.242, or 124.2%. This provides ALWC a 15% margin after taxes.

Q. Is this formula the equivalent of a “pass-through” of purchased water costs?

A. No, the unit charge is not a direct pass-through of the supplier unit charge. The Bedford Park purchased water charge is increased by the F factor, which currently is 1.242. The result is that the unit water charge ALWC charges IAWC is higher than the unit charge imposed by the supplier for purchased water. As shown on the American Lake Water Company Contract Rate Calculation for 2010-2012, Current Customers with Plainfield, provided by IAWC in response to Staff Data Request MHE 1.01, for 2010-2012 the purchased water charge of \$15,161,034 increased to \$18,830,004 by the application of the 124.20% factor.² A copy of the IAWC document is attached as AG Exhibit 1.1.

Q. Doesn't the Agreement include a provision for the “pass-through” of increased charges by ALWC suppliers?

A. Yes, but the pass-through is limited to the *increase* in the supplier charge. Section 7.5 authorizes ALWC to “immediately” add a surcharge to the calculated unit charge to include any supplier increase. It is unclear whether the F factor or the normalization factor is incorporated into the pass through of an increase, or if the increase is simply added to the unit charge based on total water delivered. See Agreement, Section 7.5

² The total Operating Cost, or OC, is \$20,011,372, which is equal to the sum of the OM Expense and the PW (\$16,112,003) times the F factor (1.242). Applying the F factor to each expense separately results in an insignificantly lower total (\$2,000), which is effectively a rounding issue.

113 **Q. Have you seen this kind of formula used in water contracts in northwest Illinois?**

114 A. No I have not. In all of the water contracts that I am aware of (including but not limited
115 to those of the DuPage Water Commission, the Northwest Suburban Municipal Joint
116 Action Water Authority and the Northwest Water Commission's) there are no provisions
117 for the formula used by ALWC. In cases I have seen, increased operation and
118 maintenance costs are passed through with no markup at all.

119
120 **Q. Do you have any other comments about the charges ALWC and IAWC customers**
121 **pay for Lake Michigan water?**

122 A. Yes. ALWC and IAWC are both owned by American Water Corporation. As a result, I
123 question what motive there is to negotiate the best price for purchased water. In fact, I
124 am concerned that there is a disincentive to negotiate a low price because ALWC makes
125 more money when the purchased water charge is higher, due to the F factor that is
126 applied to the rate. IAWC passes the total charge to its consumers, so IAWC also lacks
127 the incentive to seek a low rate.

128
129 **Q. Are other ALWC costs increased by the F factor in a manner similar to purchased**
130 **water charges?**

131 A. Yes. Section 7.1 of the Agreement defines the "Operating Charge" or OC as the sum of
132 the purchased water charges and OM, or Operations and Maintenance Expense, and the
133 same F factor is applied to the OM expense. That means that IAWC, and its consumers,
134 pay ALWC more than ALWC's actual OM expense. As shown in AG Exhibit 1.1, for

Plainfield, ALWC increased the \$950,969 O&M Expense to \$1,181,103 as a result of the 124.2% F factor.

Q. How are O&M expenses defined?

A. The Agreement defines O&M expenses on page 14. They include wages and fringe benefits, “affiliate A&G and fees,” as well as real estate, gross receipts, sales and use and invested capital taxes. In other words, under this Agreement, IAWC pays ALWC 24.2% more than ALWC pays for these expenses as a result of the F factor.

Q. Were there any OM expenses on the American Lake Water Company Contract Rate Calculation for 2010-2012 that caused you concern?

A. Yes. I was surprised to see only \$13,861 for maintenance. In my experience, that does not even cover the cost of one bad main break. I also question what they are getting for the Affiliate A&G and Fees expense, to whom they are paying a franchise fee, what rents they pay, and if they are renting, why are they paying property taxes? I also find the miscellaneous expense of \$124,706 a surprisingly high portion of the total \$950,969 O&M expense. In my budget, the miscellaneous expense is \$2,000 out of a total budget of about \$10,000,000, with \$15,000 as a contingency amount.

Q. Can ALWC’s OM expenses change from year to year?

A. Yes. Under the Agreement, the OM Expense is based on the “actual costs and expenses for the previous calendar year, as adjusted for all known and measurable changes which will occur during the following Service Period.” Agreement at 14.

158 **Q. What incentive does ALWC have to control its OM Expense?**

159 A. As is the case with the Purchased Water charge, I am concerned that there is a
160 disincentive to reduce OM expenses because ALWC makes more money when the OM
161 expense is higher, due to the F factor that is applied to the unit rate. IAWC and ALWC
162 are owned by the same parent, and IAWC passes the total charge to its consumers,
163 increasing revenues for American Water. As a result, IAWC also lacks the incentive to
164 control the OM Expense.

166 **Q. As the Executive Director of the Northwest Water Commission, what incentive do**
167 **you have to control your O&M expense?**

168 A. I am in public service. My job is to provide the best possible service to my members, in
169 this case uninterrupted water, at as low a cost as possible. This is my job. This is how my
170 performance is ultimately measured. In local government, profit is measured not in
171 dollars but in how happy your residents are. My governing Board is mostly Village
172 Managers. Each of my member villages is experiencing economic and fiscal challenges
173 and they are under enormous pressure to reduce or otherwise control costs at all level of
174 their operations. These concerns are extended to the Northwest Water Commission.
175 Fortunately, these are practices that I believe in and brought with me to the Commission.
176 The budget we present is straight-forward and is based on the belief that if something is
177 needed for the successful operation of the Commission then it will be asked for, if not,
178 then it won't. There are no "F" Factors in our contracts.

180 **Q. Does the amount the Northwest Water Commission pay the City of Evanston change**
181 **from year to year?**

182 A. Yes. Evanston charges the Northwest Water Commission 58% of its water budget, and
183 charges its residents the remaining 42%. As a result, the Evanston budget is constrained
184 by the same political accountability faced by the Northwest Water Commission.

185
186 **Q. Does the Agreement authorize other charges to IAWC?**

187 A. Yes. The purchased water and O&M expenses are part of the Unit Charge. The
188 Agreement also provides for a “Capacity Charge” in Section 7.1, (b). Although the
189 Agreement is somewhat unclear at page 13, AG Exhibit 1.1, page 2 shows that the
190 Capacity Charge starts with the total invested capital (\$49,687.634), which is allocated to
191 each leg of the pipeline. The allocated amount is then multiplied by 2.5%, representing
192 the amount recovered in rates each year. ALWC then applies the F factor to the result for
193 each leg of the pipeline, so that the total capital cost includes 2.5% of the investment,
194 multiplied by the 124.202% factor. For 2010-2013, AG Exhibit 1.1 shows the following:

Total Lake Water	\$49,687,643
System Cost @ 2.5%	\$ 1,242,191
F Factor (* 1.24202)	\$ 1,542,822.

198
199 **Q. What is the effect of this calculation?**

200 A. The effect is that IAWC and its customers pay ALWC \$300,631 or 24.2% of the capacity
201 allocated for each year to cover the cost of ALWC’s investment.

203 **Q. Does the Agreement itemize the sources of capital used for this investment?**

204 A. No.

206 **Q. Doesn't the Northwest Water Commission also pay a return on investment for its**
207 **infrastructure and pipeline?**

208 A. Yes, the Northwest Water Commission's agreement with the City of Evanston includes a
209 return on investment of 9.5%. This agreement was negotiated in 1985, when interest
210 rates were much higher than they are today. The Commission pays a three part rate to
211 the City of Evanston. One component is the fair value rate base which is a combination of
212 the Original Cost Less Depreciation and Replacement Cost New Less Depreciation. We
213 pay a rate of return of 9.5% of this value. The other two components are depreciation
214 and Evanston's operating cost. We do not pay a return on these expenses. At the end of
215 each year, there is a true-up between Evanston and the Northwest Water Commission to
216 set the per-unit cost going forward. All told, the cost of the 9.5% rate on the investment
217 is about 19 cents per thousand gallons, the depreciation charge is about 3 cents per
218 thousand gallons, and the per unit operating cost is about 35 cents per thousand gallons
219 for a total cost of about 57 cents per thousand gallons. The Northwest Water
220 Commission's "mark up" for its salaries, electricity, insurance, maintenance, etc is about
221 34 cents per thousand gallons and its debt service is about 25 cents per thousand gallons.
222 In total, we pay Evanston 57 cents per thousand gallons and our expenses are 59 cents per
223 thousand gallons. Under the Agreement IAWC is charged \$3.0569 by Bedford Park, and
224 it imposes another \$1.289 for ALWC charges. See IAWC Ex. 2.1.

226 **Q. Are there provisions of the Agreement other than the calculation of the rates that**
227 **you would like to comment on?**

228 A. Yes. The Agreement requires IAWC to “exercise Reasonable Best Efforts to take Lake
229 Michigan Water from ALWC at a uniform rate of flow.” Agreement at page 4. When
230 pumping and electricity are required for the delivery of water, it is often economical to
231 take more delivery at night, when electricity costs are low. Subject to operational
232 constraints, ALWC should not limit IAWC’s options to reduce its own operating costs by
233 filling its storage tanks during off-peak hours.

234
235 **Q. Do you have any comment on the 1.5% monthly interest rate provided for in Section**
236 **8.1(a) of the Agreement?**

237 A. It is not unusual to impose a 1.5% monthly interest rate for late payments. However, in
238 this case the debtor (IAWC) and the creditor (ALWC) are related companies, so the
239 payment is from one pocket to the other of the same ultimate owner. If there are late fees
240 assessed, IAWC’s customers would presumably be paying the charge, shielding IAWC’s
241 revenues from any effect and potentially removing IAWC’s incentive to avoid such
242 charges. The Commission should be careful to assure that late payment fees are not
243 incurred on a regular basis because although a 1.5% per month fee seems low, on an
244 annual basis it represents an 18% charge.

245
246 **Q. Do you have any other comments on the Agreement?**

247 A. I am concerned about accountability, in that ALWC is not accountable to IAWC or to
248 consumers the way that elected officials are accountable. In fact, ALWC’s main concern

249 is its shareholders, and that interest can be at odds with the consumer's interest in fair and
250 reliable water service. In a local government, elected officials are accountable to the
251 voter and are ever cognizant of this fact. In addition, the elected official is also a user of
252 the system. In the case of private utilities that have contracts with unregulated, private
253 affiliates, there is no direct public accountability, leaving it up to the Illinois Commerce
254 Commission to insure that the contract between private, affiliated companies and the
255 affiliated company's costs are fair to consumers and consistent with local practices and
256 prices.

257
258 **Q. Does this conclude your testimony?**

259 **A. Yes.**